

VZCZCXRO3797  
RR RUEHRG  
DE RUEHSO #0216/01 0991335  
ZNR UUUUU ZZH  
R 091335Z APR 09  
FM AMCONSUL SAO PAULO  
TO RUEHC/SECSTATE WASHDC 9101  
INFO RUEHBR/AMEMBASSY BRASILIA 0248  
RUEHRG/AMCONSUL RECIFE 4344  
RUEHRI/AMCONSUL RIO DE JANEIRO 9106  
RUEHBU/AMEMBASSY BUENOS AIRES 3470  
RUEHAC/AMEMBASSY ASUNCION 3717  
RUEHMN/AMEMBASSY MONTEVIDEO 2891  
RUEHSG/AMEMBASSY SANTIAGO 2717  
RUEHLP/AMEMBASSY LA PAZ 4094  
RUCPDO/USDOC WASHDC 3261  
RUEATRS/DEPT OF TREASURY WASHDC  
RHEHNSC/NATIONAL SECURITY COUNCIL WASHDC

UNCLAS SECTION 01 OF 03 SAO PAULO 000216

SIPDIS  
SENSITIVE

STATE PASS USTR FOR KDUCKWORTH  
STATE PASS EXIMBANK  
STATE PASS OPIC FOR DMORONSE, NRIVERA, CMERVENNE  
STATE PASS NSC FOR ROSSELLO  
DEPT OF TREASURY FOR LINDQUIST

E.O. 12958: N/A  
TAGS: [ECON](#) [EFIN](#) [BR](#)  
SUBJECT: BRAZIL'S ECONOMY: SLIDING BELOW ZERO PERCENT GROWTH

REF: A. Brasilia 257; B. Brasilia 141

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: Brazil's growth has collapsed more sharply than might be expected given the country's limited dependence on exports and limited leverage in the banking, corporate, and household sectors. The more important transmission channel of weak global conditions is probably its negative effect on consumer and business confidence and domestic demand. In this environment, domestic macroeconomic stimulus may have only limited impact. Fiscal expansion will require time to take effect and is unlikely to have much impact in 2009. Monetary policy is also facing headwinds - most immediately, a decline in the money multiplier effect and reduced willingness to spend by the private sector. Senior officials at the Brazilian Central Bank (BCB) told the Treasury Attache that they feel monetary policy is now "pushing on a string" and that further rate cuts are unlikely to have a meaningful effect on Brazil's growth this year. Brazil is thus unlikely to regain growth until global conditions improve. However, the global recession is also unlikely to do lasting harm to Brazil's fiscal and external accounts. With a global pickup in 2010, Brazil could grow by 3.5 percent next year. End Summary.

Growth Bad and Getting Worse  
-----

¶2. (SBU) After growing by 5.7 percent in 2007 and 5.1 percent in 2008, the current consensus among financial institutions in Brazil is that the country's economy should contract by at least 0.2 percent this year. (Note and Comment: While official GDP growth forecasts by the Ministry of Treasury have been sliding, the Ministry has maintained a more positive outlook of 2% GDP growth. Post has yet to encounter any financial institution, economist, or academic who supports this assessment. End Note and Comment.) Itau economist Mauricio Oreng was less hopeful and told Econoff that Itau expects total GDP growth to fall by 1.5 percent this year. Morgan Stanley was even more pessimistic and is forecasting a contraction of 4.5 percent. Over the past quarter, several key indicators have collapsed and dropped to levels not seen in nearly two decades. Sectors most strongly affected by the current downturn include agriculture, construction, and, until recently, autos. Zero percent growth implies that Brazil will produce roughly USD 60 billion less than at full production capacity.

13. (SBU) The GOB has responded aggressively to the downturn (Ref A). The BCB cut its base rate by 250 points and is likely to cut another 300 points in coming months. The BCB made a similar move reducing bank reserve requirements by R\$ 100 billion (3.5 percent of bank assets). New lending facilities have helped to inject liquidity, boost trade finance, and facilitate private sector external debt servicing. Public banks have increased lending to farmers, builders, and in support of capital projects. The BCB has also allowed the real, trade-weighted value of the exchange rate to fall by 23 percent since last September.

14. (SBU) The GOB resisted fiscal stimulus until recently. Although its public debt ratios are now far lower than they were several years ago (net debt is approximately 37 percent of GDP), Brazil has been cautious about large-scale fiscal expansion given its history of large deficits and concerns that new spending might harm its risk premium. In March, however, Brazil announced a USD 15 billion spending program (approximately 1.1 percent of GDP) to build one million low income housing units over the next three years. While these new expenditures will provide stimulus more directly than rate cuts, expected lags in implementing the program will limit stimulus effects in 2009 (to approximately 0.4 percent of GDP). Brazil's total fiscal stimulus to date is 1.3 percent of GDP (including a temporary car tax reduction that took effect in January, Ref B).

15. (SBU) Despite fiscal and monetary stimulus measures, however, private sector spending has continued to decline. As a result, aggregate demand has continued to fall and Brazil's GDP forecasts have been repeatedly revised down in recent months.

SAO PAULO 00000216 002 OF 003

#### Well-Protected but Still Affected

-----

16. (SBU) Given the severe downturn in global economic conditions, it is not surprising that Brazil is suffering spillover effects; however, the speed and extent of the impact has been surprising. Economic interlocutors had touted Brazil's sound fundamentals and the relatively closed economy to protect Brazil from the global recession. The relatively large size of Brazil's government (public spending represents 41 percent of GDP) should have provided strong automatic stabilizers. Likewise, declining inflation pressures created ample room for the BCB to continue aggressively reducing interest rates. Brazil's balance of payments is in good shape, including continued strong FDI inflows and USD 200 billion in foreign reserves. The private sector is only leveraged by 41 percent of GDP, and private banks have strong solvency ratios and liquidity positions (16 percent average capital adequacy). Finally, Brazil is well positioned due to its relatively closed economy, (exports total only about 13 percent of GDP), and limited dependence among Brazilian institutional borrowers on external market finance (seven percent of total financing comes from external sources).

#### Exports and Credit

-----

17. (SBU) Despite all the insulation against the crisis, the finance sector's consensus estimate for Brazil's growth this year is for a contraction of 0.19 percent. Estimated GDP growth figures for 2009 have continued to be revised downward over the last three months. While both falling exports and tightened credit conditions are often blamed, neither factor explains the decline in economic growth. Exports have taken a hit given the lack of global consumption, down by 14.9 percent in March compared to last year; however, imports are also declining, and the net effect that trade flows will have on GDP this year should be roughly neutral. More importantly, however, Brazil's economy is not export-intensive. While exports are critical for specific sectors (e.g., autos, metals, agriculture), exports have fairly limited direct impact on total output. Brazil's export-to-GDP ratio (13 percent) is well below countries such as Korea (45 percent), China (40 percent), and India (22 percent).

18. (SBU) While Brazil's credit channels have tightened, Brazil has suffered only relatively modest deleveraging effects compared to

many other countries. Over the past quarter, credit growth has slowed but has not stopped. Credit to the private sector is expected to grow by roughly 12 percent in 2009 - far slower than the 30 percent annual growth rate observed in 2007-2008, but not slow enough to justify negative GDP growth. Except for a brief period in the final quarter of 2008, high-quality borrowers report that credit flows continue (though at shorter tenors and with more collateral). Brazil's rates spiked last November, but rates have fallen on average by nearly 10 percent since then. According to the BCB, the overall delinquency rate rose 0.4 percentage points over the last 12 months, but remains at only 4.8 percent of total lending. (See forthcoming Septel for more on credit conditions in Brazil.)

#### Confidence to Blame

¶9. (SBU) The most likely explanation for Brazil's current recession is the recent steep decline in confidence and its negative impact on consumption and investment spending. Since last April, consumer confidence has fallen by nearly 15 percent. Because household consumption represents the largest share of output (62 percent), GDP is sensitive to even small shifts in consumption patterns. Consumption has also been Brazil's most important engine of growth over the past five years. While investment represents a far smaller share of output (18 percent), it will decline by about 11 percent this year. Consumption and investment are both expected to contribute negatively to GDP growth in 2009. The most important transmission effect the global recession has had on Brazil's economy has therefore probably been its negative effect on domestic confidence and spending.

¶10. (SBU) Low consumer confidence is also closely related to a

SAO PAULO 00000216 003 OF 003

weakening labor market. Over the past four months, Brazil's unemployment rate (8.5 percent) has risen by a percentage point and may reach 10 percent by the end of 2009. Average monthly earnings in January were 15 percent below their level one year ago. Consumer defaults (8.4 percent) have risen by 17 percent over the past 12 months. While most Brazilians deposit their savings in banks rather than invest in equities, the decline in Brazil's stock exchange (32 percent in the past year) has also probably hurt confidence.

¶11. (SBU) Weak confidence is both bad news and good news. In the near-term, weak confidence is a problem because it cannot be reversed with a macroeconomic policy response. President Lula and Central Bank President Meirelles have both unsuccessfully sought to encourage greater private sector spending by stressing Brazil's strong fundamentals and the benefits that interest rate cuts should bring. Absent greater willingness to spend by Brazil's private sector, however, this stimulus is likely to have only a limited impact. Brazil's central bankers have told the Treasury Attache that they feel they are now "pushing on a string" and that further rate cuts are unlikely to strengthen growth this year.

#### It's Only Temporary

¶12. (SBU) The good news is that the confidence crisis Brazil is suffering is likely to represent a temporary rather than a permanent shock. Unlike many other countries, Brazil does not need to comprehensively restructure its balance sheets, borrow extensively from international financial institutions to avoid default, or worry about large increases in its public sector debt as a result of the global recession. Brazil's challenge is a cyclical slump rather than a need for major structural reforms or a deterioration in its core economic fundamentals.

#### Comment

¶13. (SBU) Like other emerging markets, Brazil is highly unlikely to regain growth until global conditions improve. As Brazil's largest trading partner and foreign investor (16 percent of exports), the U.S. outlook is most important. China is also critical due to the commodity-intensive nature of its imports and the fact that it is

Brazil's fastest growing trade partner. Strong fundamentals should help Brazil re-establish growth more quickly than many other countries. The global recession is also unlikely to do lasting harm to Brazil's fiscal and external accounts. The current financial community consensus is that Brazil will quickly exit the world recession and grow by 3.5 percent in 2010, a rate considered to be close to Brazil's potential rate of growth. End Comment.

¶14. (U) This cable was coordinated/cleared by Embassy Brasilia and written in conjunction with the Treasury Financial Attache in Sao Paulo.

WHITE